

SELLER CONTROL OF UNSECURED TRADE CREDIT

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I. INTRODUCTION

Many manufacturers, producers, and wholesalers in various types of businesses offer unsecured credit terms. Moreover, retailers, manufacturers, processors, and building contractors alike depend on such unsecured trade credit.¹ Unsecured credit terms usually require payment 30, 60 or 90 days following the invoice, shipping, or billing date. Frequently a discount is offered for prepayment. Secured credit is ordinarily used when the payment period is longer.²

Sales on unsecured credit involve risks that are both foreseeable and unforeseeable. A fair estimate of whether a buyer will be able to pay can be made where credit is offered for only thirty days, since only a short time will elapse between the contracting and delivery dates. In many cases, as when goods are specially manufactured, delivery may be delayed for a substantial period of time after acceptance of an order, thus making a credit risk more difficult to determine. Furthermore, a credit risk may be even harder to assess where the contract provides for installment deliveries over a period of several months or years. Sometimes foreseeable credit problems are not foreseen either because the seller fails to obtain available credit information or because he cannot secure it quickly enough. Finally, and more importantly, competitive pressures lead many sellers to extend unsecured credit to high-risk customers.

Thus, a seller may be confronted with credit risks that increase materially in the interval between contracting and delivery or between deliveries. If such risks do increase, can the seller refuse delivery except for cash, or in the alternative, require security from the buyer? Furthermore, since his statutory remedies are deficient, can the seller by contract meet later developing contingencies affecting the credit risk? Despite their considerable importance and many complexities, these questions have been given surprisingly little attention,³ surely less than they deserve. This article

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¹ See R. JOHNSON, *FINANCIAL MANAGEMENT* 298-301 (3d ed. 1966); C. DAUTEN & M. WELSHANS, *PRINCIPLES OF FINANCE* 186 (3d ed. 1970); E. WALKER, *ESSENTIALS OF FINANCIAL MANAGEMENT* 105-15 (1965).

² For a summary of the usual terms of sale for various products, see R. COLE & R. HANCOCK, *CONSUMER AND COMMERCIAL CREDIT MANAGEMENT* 323-43 (rev. ed. 1964); T. BECKMAN, *CREDITS AND COLLECTIONS* 639-44 (7th ed. 1962).

³ Williston carried his analysis no further than the case where the buyer is actually insolvent. See 3 S. WILLISTON, *SALES* § 577 (rev. ed. 1948). Neither of the two works dealing with the UNIFORM COMMERCIAL CODE includes any treatment of the question. See W. HAWKLAND, *A TRANSACTIONAL GUIDE TO THE UNIFORM COMMERCIAL CODE* (1964); R. DUESENBERG & L. KING, *SALES AND BULK TRANSFERS UNDER THE UNIFORM COMMERCIAL CODE* (1966).

will examine the seller's statutory remedies by way of an illustrative example, and will follow with some suggestions about contract drafting to secure credit control for the seller.

For the example, suppose that: Producers Association, a farmers' co-operative, sells fluid milk to various dealers, one of which is Select Dairy Products. By the contract Producers must furnish Select's requirements over the next three years. Deliveries are to be made on an unsecured open account with payment due at the end of the following month. After a year, Select's financial condition reaches a point of imminent insolvency, which forces Producers to make a decision about withholding further credit. Producers could continue to deliver on credit, but if Select fails, most of the account will be a total loss. Yet if Producers refuses further account credit, Select cannot readily pay cash and no other supplier is likely to extend unsecured credit. Moreover, Select has previously tied up its vehicles, inventories, and accounts receivables as collateral for equipment and working capital loans from a local bank, which has refused to advance any additional funds. To complicate matters further, Select has remained current on its account with Producers. Assuming that the Uniform Commercial Code controls, Producers has three courses of action—none of which is satisfactory.⁴

II. THE SELLER'S REMEDIES

A. *Reclamation of Delivered Goods*

One alternative for Producers is to continue deliveries on the same terms. However, this alternative is likely to yield unsatisfactory results if insolvency does occur. While § 2-702(1) provides that if the seller discovers his buyer to be insolvent, "he may refuse delivery except for cash including payment for all goods theretofore delivered. . .",⁵ payment for goods already delivered is the real problem. § 2-702(2) specifies that:

Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt. . . .⁶

⁴ All citations are to the 1962 Official Text of the UNIFORM COMMERCIAL CODE [hereinafter cited as U.C.C.].

⁵ U.C.C. § 2-702(1). § 1-201(23) provides that:

A person is "insolvent" who either has ceased to pay his debts in the ordinary course of business or cannot pay his debts as they become due or is insolvent within the meaning of the federal bankruptcy law.

§ 1(19) of the Bankruptcy Act, 11 U.S.C. § 1(19) (1964), provides that:

A person shall be deemed insolvent within the provisions of this title whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts.

⁶ U.C.C. § 2-702(2). The subsection continues providing that:

... if misrepresentation of solvency has been made to the particular seller in writing

In many instances, as here, this remedy has little value, since inventories may be sold or deteriorate quickly. Whether the remedy enables the seller to reach the proceeds of goods subject to reclamation is questionable.⁷

Moreover, the potential claim of the trustee in bankruptcy must be considered. Before a 1966 amendment,⁸ § 2-702(3) subjected the reclaiming seller to the rights of a lien creditor. One court has held that pre-Code law determines these rights, and that by such pre-Code Pennsylvania law the reclaiming seller was subordinated to the rights of a lien creditor who extended credit after delivery of the goods and that the trustee in bankruptcy had the rights of such a lien creditor.⁹

Finally, as in this example, reclamation of the goods may be contested by a third party who holds a security interest that attached when the goods were delivered. Relying on § 2-403(1),¹⁰ two courts have held that a party having such an interest takes priority over the seller whose claim is based on § 2-702(2).¹¹ However, even if Producers can successfully reclaim the goods, it cannot reach goods delivered prior to insolvency and for which payment has not been received.

B. *Refusing Delivery Except for Cash*

Producers' second alternative would be to disregard the credit term and demand cash on delivery, relying on § 2-702(1). Under this section any right to eliminate the credit term depends on whether the buyer is in fact "insolvent."¹² Since demanding cash could force the buyer out of business, the consequences of an incorrect prediction may rule out any such demand as a practical alternative.

within three months before delivery the ten day limitation does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

⁷ If the seller held an Article 9 security interest, it would be carried over to the proceeds. See U.C.C. § 9-306(2). By analogy the same result should be reached here.

⁸ REPORT NO. 3 OF THE PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, published in 1967, recommended that the words "or lien creditor" be deleted from § 2-702(3), which now reads:

The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser under this Article (Section 2-403). Successful reclamation of goods excludes all other remedies with respect to them.

⁹ *In re Kravitz*, 278 F.2d 820, 822 (3d Cir. 1960). *Contra, In re Mel Golde Shoes, Inc.*, 403 F.2d 658 (6th Cir. 1968); *In re Royalty Homes, Inc.*, 8 U.C.C. Rep. 61 (E.D. Tenn. 1970).

¹⁰ U.C.C. § 2-403(1). The section provides, so far as here relevant, that "[a] person with voidable title has power to transfer a good title to a good faith purchaser for value."

¹¹ *In re Hayward Woolen Co.*, 3 U.C.C. Rep. 1107 (D. Mass. 1967); *First-Citizens Bank & Trust Co. v. Academic Archives, Inc.*, 10 N.C. App. 619, 179 S.E.2d 850 (1971).

¹² See note 3 *supra*.

C. *Demanding Security for Deliveries on Credit*

The third alternative is an intermediate position. Under § 2-609,¹³ if there are "reasonable grounds for insecurity" concerning Select's ability to pay for future deliveries, Producers can demand "adequate assurance" that such payments will be made. If the demand is justified and such assurance is not furnished "within a reasonable time not exceeding 30 days," Producers could then "cancel" the contract. And, until receiving such assurance, Producers may, "if commercially reasonable," suspend any further performance.

As an adequate assurance the seller can demand a financial statement evidencing not only solvency but also a probable ability to pay when the account becomes due. What constitutes a sufficient showing of probable ability to pay will be a difficult question in many cases. But, assuming that the financial statement shows solvency coupled with a minimal chance of survival for long enough to pay, what rights does Producers then have?

Arguably at least, Producers could demand as adequate assurance of payment that Select either pay cash on a daily basis for future deliveries or allow Producers to retain a purchase money security interest in any milk delivered on credit. Even though Select's inventories are already subject to another security interest, Producers can retain a "purchase money security interest"¹⁴ in the milk delivered on credit. This interest would have priority over any other interest in the collateral regardless of when the other interest was taken. But to obtain this priority, Producers must, before delivering the goods, notify any party who had previously filed a financing statement providing for a security interest in the inventory collateral.¹⁵

There are several reasons for Producers to reserve a purchase money security interest. Not only would Producers obtain a priority in Select's inventory, it also would obtain a security interest in the proceeds generated by the sale of milk by Select¹⁶ which might take priority over security in-

¹³ U.C.C. § 2-609. The section provides that:

(1) A contract for sale imposes an obligation on each party that the other's expectation of receiving due performance will not be impaired. When reasonable grounds for insecurity arise with respect to the performance of either party the other may in writing demand adequate assurance of due performance and until he receives such assurance may if commercially reasonable suspend any performance for which he has not already received the agreed return.

(2) Between merchants the reasonableness of grounds for insecurity and the adequacy of any assurance offered shall be determined according to commercial standards.

(4) After receipt of a justified demand failure to provide within a reasonable time not exceeding thirty days such assurance of due performance as is adequate under the circumstances of the particular case is a repudiation of the contract.

¹⁴ See U.C.C. § 9-107.

¹⁵ See *id.* § 9-312(3). For the definition of inventory, see § 9-109(4).

¹⁶ See *id.* § 9-306(2).

terests of third parties in the same proceeds.¹⁷ Moreover, if Select is later adjudicated a bankrupt, Producers' purchase money security interest would not be a preference¹⁸ subject to avoidance by Select's trustee in bankruptcy, even if Select were then insolvent and the bankruptcy occurred within four months. No preference arises unless there is a "transfer" of Select's property "for or on account of an antecedent debt." The taking of the security interest would not amount to a transfer "for or on account of an antecedent debt" if the interest attached before Select "accepted" the goods,¹⁹ since Select's indebtedness for the purchase price would be established by the acceptance.²⁰

Furthermore, Producers must perfect its security interest so that the "transfer" occurs when the interest attaches to the collateral. To do this, Producers must file a financing statement within ten days after Select takes possession of the collateral. According to § 60a(2) of the Bankruptcy Act, any "transfer":

... shall be deemed to have been made . . . when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee.²¹

Section 301(2) gives Producers ten days after Select takes possession of the collateral in which to file a financing statement. If Producers files within the ten days, it "... takes priority over the rights . . . of a lien creditor which arise between the time the security interest attaches and the time of filing."²² Since under state law the delayed filing is effective against an intervening lien creditor, the application of § 60a(7) of the Bankruptcy Act produces a similar result against the trustee in bankruptcy:

... if the applicable law requires a transfer of property . . . to be perfected by recording . . . in order that no lien described in paragraph (2) of this subdivision could become superior to the rights of the transferee . . . the time of transfer shall be determined by the following rules:

¹⁷ See 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 29.4 (1965) for analysis.

¹⁸ Bankruptcy Act § 60a(1), 11 U.S.C. § 96a(1) (1964), provides that:

A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.

Bankruptcy Act § 60b, 11 U.S.C. § 96b (1964), provides that:

Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent.

¹⁹ See U.C.C. § 2-606 for when acceptance occurs.

²⁰ *Id.* § 2-607(1). See also §§ 2-507(1) and 2-601.

²¹ Bankruptcy Act, 11 U.S.C. § 96(a)(2) (1964).

²² U.C.C. § 9-301(2).

I. Where (A) the applicable law specifies a stated period of time of not more than twenty-one days after the transfer within which recording . . . is required, and compliance therewith is had within such stated period of time . . . the transfer shall be deemed to be made or suffered at the time of the transfer.²³

After considering the advantages of obtaining a purchase money security interest, the question then is whether Producers can require Select to accept the goods subject to the reserved interest. Apparently, the draftsman of § 2-609 thought that in some cases "adequate assurance of due performance" would require a buyer to do something beyond furnishing a financial statement. Comment 4 to § 2-609 suggests that in some instances the seller could properly demand security as "adequate assurance" of payment:

However, the seller is reasonably entitled to feel insecure at a sudden expansion of the buyer's use of a credit term, and should be entitled either to security or to a satisfactory explanation.²⁴

Although this article is not concerned with a buyer's use of a credit term, Comment 4 does suggest at least one circumstance in which security could be properly demanded.

The only pre-Code case in point is *F. W. Kavanaugh Manufacturing Co. v. Rosen*,²⁵ a decision by the Michigan Supreme Court. The seller, relying on a report that the buyers were in a questionable financial condition, refused to deliver goods on credit as the contract required. The court held that it was irrelevant that the seller might have believed in good faith that the buyers would be unable to pay:

It was open to the plaintiff [seller] to investigate the financial condition of defendants before making the contract. Failing to do this, nothing short of a breach of contract upon defendants' part, or actual insolvency, would excuse the plaintiff from fulfilling the contract on its part. Any other rule would leave a purchaser at the mercy of the seller, and could not afford a safe rule for the transaction of business.²⁶

Section 2-609 modifies this pre-Code decision. The seller can insist on some adequate assurance of payment, and he can, if "commercially reasonable," suspend deliveries until receipt of such assurance. Even so, it can be assumed that many courts would be reluctant to find that a right to adequate assurance under § 2-609 authorizes the seller either to eliminate a credit term or to alter the type of credit by permitting the seller to reserve a purchase money security interest in the delivered goods. It would be easier to persuade a court that the change in the type of credit, rather

²³ Bankruptcy Act, 11 U.S.C. § 96(a)(7) (1964).

²⁴ U.C.C. § 2-609, Comment 4.

²⁵ 132 Mich. 44, 92 N.W. 788 (1902).

²⁶ *Id.* at 48, 92 N.W. at 790.

than a complete elimination of credit, is not beyond the scope of "adequate assurance."

Assuming that the seller demands cash and that the buyer is unable either to meet the demand or obtain another supplier willing to deliver on similar credit terms, few courts are likely to condone such a demand if it forces the buyer out of business. Furthermore, the seller can bargain for control of credit terms. So, if the seller could have obtained control of the credit by contract terms, some courts may be reluctant to hold that the loose statutory language referring to "adequate assurance of due performance" enables him to demand security.²⁷ Finally, Select may have agreed with its lending bank not to encumber its inventories, a common requirement of bank financing. The fact that granting a security interest to Producers would put Select in default on its contract with the bank might be relevant to a court deciding whether Producers was justified in refusing delivery unless its demand for the security interest were granted. Is it ever proper for a seller to demand an assurance which forces a buyer into default on his contract with a third party?²⁸ Regardless of the answer to this question, the arguable propriety of demanding either cash or security may be all that the seller needs in dealing with the buyer's other creditors. That the seller *might* have the right to demand cash or security could be enough to persuade the buyer's financing bank to make further advances to the buyer, reduce the buyer's payments, or agree to share the collateral with the seller. Moreover, because of the type of collateral involved, the secured party will often make an effort to keep the buyer going. Here, for instance, the bank might realize very little on Select's receivables once Select has gone out of business.

D. *The Buyer's Remedy if the Seller Incorrectly Predicts Buyer Insolvency*

Where there is a substantial risk that insolvency may intervene before payment is due and made, it is arguable that § 2-609 enables a seller like Producers to insist upon reserving a security interest in goods delivered on credit. But assume that Producers refuses to deliver except for cash on delivery or upon the retention of a security interest when it has no right to make such a refusal. What remedies does Select, the buyer, have which must be considered by Producers prior to this refusal to deliver?

Although the weight of authority is that a contract to advance money or extend credit will not be specifically enforced,²⁹ perhaps Select could secure an order requiring deliveries to be continued on the original credit

²⁷ The section could hardly have been drafted with greater specificity, given the wide range of cases it was meant to reach.

²⁸ But, the seller is not trying to induce a breach of contract by the buyer; he is simply demanding that the buyer secure a modification of the loan agreement if he expects the seller to continue deliveries on credit.

²⁹ H. MCCLINTOCK, *PRINCIPLES OF EQUITY* § 60 (1948).

terms.³⁰ If so, a persuasive argument still can be made that such relief should not be granted except on the condition that Producers be permitted to retain a security interest in the delivered milk. The 1932 Restatement, Contracts, provides:

Specific enforcement may properly be refused if a substantial part of the agreed exchange for the performance to be compelled is as yet unperformed and its concurrent or future performance is not well secured to the satisfaction of the court.³¹

There is authority for the position that performance, Select's payment, would not be "well secured" unless Producers were permitted to retain a security interest in the delivered milk.³²

III. CONTRACT DRAFTING FOR CREDIT CONTROL³³

Because of the uncertainties inherent in the remedy provided by § 2-609, only a carefully drafted term will secure the credit control required by the seller. Whether the seller will be able to impose contractual credit controls on the buyer is quite another matter. Efforts to introduce such controls may be resented, particularly where the kind of control is new. Moreover, it is reasonable to ask whether any contract term will afford the seller adequate protection where the credit risk is substantial: If the risk is so substantial that contractual controls are needed, does it make sense for the seller to agree to anything less than wholly secured credit, with at least a purchase money security interest in whatever he delivers? While generally there may be no middle ground between secured and unsecured credit, in a substantial number of instances the seller may be unable to obtain any kind of security—as in the Producers/Select example previously stated. Notwithstanding his inability to impose secured credit terms in these instances, the seller may still want to transact business, provided that he can otherwise reduce his credit risk. The question then is how to establish a workable means for the seller contractually to control extensions of credit.

A. *Requiring the Buyer to Complete the Contract*

When faced with a developing credit problem, the seller ordinarily will want to be able to demand cash and to enforce the contract if the

³⁰ There are no cases in point, but some courts have granted specific performance of contracts to advance money. See, e.g., *Columbus Club v. Simons*, 110 Okla. 48, 236 P. 12 (1925), noted in 24 MICH. L. REV. 195 (1925); *Jacobson v. First Nat'l Bank*, 129 N.J. Eq. 440, 20 A.2d 19 (1941), *aff'd mem.*, 130 N.J. Eq. 604, 23 A.2d 409 (1942), noted in 40 MICH. L. REV. 303 (1941); *City of Camden v. South Jersey Port Comm'n*, 4 N.J. 357, 73 A.2d 55 (1950).

³¹ RESTATEMENT OF CONTRACTS § 373 (1932).

³² *Van Scoten v. Albright*, 5 N.J. Eq. 467 (1846).

³³ The single article dealing with the subject is Havighurst, *Clauses in Sales Contracts Protecting the Seller Against Impairment of the Buyer's Credit*, 20 MINN. L. REV. 367 (1936), a thorough analysis of several matters considered here.

buyer fails to comply with his demand.³⁴ That is, the seller will want a term both enabling him to close out the contract by cancellation if his demand for cash is not met and enabling him to enforce the contract by a damage recovery if the buyer refuses to go forward on a cash basis. That such a term should be framed to insure the right to enforce may seem so obvious as to require no mention, except that the language required to insure the right has been the subject of enough litigation³⁵ to suggest some care in drafting. A simple precaution would be to add, following reservation of the right to demand cash, that "the buyer must accept and pay for goods tendered after any such demand is made."

B. *The Right Reserved: Changes in Payment Terms*

By a properly drafted clause, the seller can be empowered to make three important types of changes in payment terms: (1) to advance the time for payment of the price, liability for which was incurred by the buyer's acceptance of the goods; (2) to eliminate the credit period before it commences to run; that is, to require payment on delivery; or, (3) not only to eliminate credit, but to require also that payment be made on some date before delivery.

Since eliminating credit after delivery, especially by accelerating the time for payment without notice, is likely to result in hardship for the buyer, § 1-208 strictly limits the seller's exercise of any such reserved right.³⁶

³⁴ If he has the right to require cash, of course it follows that on a refusal to pay the seller may then cancel, U.C.C. § 2-703(f), but not without first making the demand. See *Peierls, Buhler & Co. v. Newburger*, 202 App. Div. 471, 195 N.Y.S. 142 (1922), *aff'd mem.*, 236 N.Y. 537, 142 N.E. 274 (1923).

³⁵ In *James B. Berry's Sons Co. v. Monark Gasoline & Oil Co.*, 32 F.2d 74, 75 (8th Cir. 1929), the term provided that:

In the event that payment for goods shipped is not promptly made in accordance with the terms of this sale; or in the event that the credit or the financial responsibility of the purchaser becomes impaired or unsatisfactory to the seller, the seller reserves the right to demand cash or satisfactory security before making shipments. Upon the failure of the buyer to provide cash or satisfactory security to fully satisfy the seller's demands, the seller reserves the right to discontinue making shipments and to cancel the sale, or any part of the sale, thereby terminating all obligation on the part of the seller for delivery of the goods, of any part of the goods sold. . . .

Notwithstanding that the only stated remedy was to cancel, the court held that the buyer was required to accept and pay for the goods. *Accord*, *Louis Stern Sons, Inc. v. Adolf Gobel, Inc.*, 113 F.Supp. 853 (D.N.J. 1953).

In *Dery v. Blate*, 239 N.Y. 203 at 205, 146 N.E. 204 (1924), the agreement was that "[t]he amount of credit to be extended to buyer may be determined at any time by seller." The court held that if his demand for cash were refused, the seller could not force the buyer to go forward on a cash basis:

. . . [T]o what extent did the purchasers put themselves to the mercy of the seller? . . .
 . . . In fairness it can be said to serve no useful purpose except to protect him from an extension of credit on the terms specified therein in an amount deemed by him unsafe. *Id.* at 206, 146 N.E. at 205.

³⁶ U.C.C. § 1-208. The section provides that:

A term providing that one party or his successor in interest may accelerate payment or performance or require collateral or additional collateral "at will" or "when he deems himself insecure" or in words of similar import shall be construed to mean

However, such an acceleration clause is not needed to deal with the sort of short term credit risk here examined. The typical acceleration clause is designed to meet the risk entailed by a relatively long credit period, as when goods are delivered in a single installment and the credit term runs for at least six months, and usually for 12, 18, or even 36 or 48 months.

By contrast, the type of contract here examined calls for installment deliveries and only a short credit period of 30, 60, or 90 days for each installment. The primary risk is created by the buyer's condition for a brief interval between contracting and delivery, or between deliveries. Here, all that the seller reasonably requires is the right to eliminate credit and demand payment on delivery. By this option to eliminate credit before delivery, the seller obtains precisely the right he would have had if the contract had not dealt with the matter of payment—the right to have payment in exchange for his goods.³⁷ With respect to hardship for the buyer, there is obviously a large difference between eliminating a 36 month credit period, on one hand, and eliminating credit which would have run for only 30 days, on the other.

Not surprisingly, an occasional draftsman is unable to select language appropriate for insuring such a right to require payment on delivery. Thus, in *Raw Silk Trading Co. v. Katz*,³⁸ when a seller had demanded cash relying on a term that provided: "Subject to credit limit at seller's discretion," the court answered by holding:

It is fairly debatable as to what is meant by the words "credit limit." They might refer either to a limitation of credit in respect of the quantity of goods to be delivered, thus limiting the amount or extent of credit to be given to the customer upon the terms mentioned in the contract as to time of payment, or they might refer to a limitation of the time of the credit for the amount of the goods mentioned in the contract. But upon either construction of the contract, the fact is that the act of the [seller] resulted in giving no credit whatever, since it demanded cash on delivery, which could hardly be regarded as a *limitation of credit*.³⁹

A third, and seldom used type of clause, enables the seller not only to eliminate the right to credit, but also to require payment at some date before delivery. Such a term is necessary in only a limited number of instances, usually where a contract is for goods specially manufactured to the buyer's order. Here, the credit risk is not only that the buyer may be unable to pay, but also that the seller may be unable to realize much on resale of the goods if the buyer is unable to pay cash. The seller wants to be able to insist on some assurance of payment before he actually com-

that he shall have power to do so only if he in good faith believes that the prospect of payment or performance is impaired. The burden of establishing lack of good faith is on the party against whom the power has been exercised.

³⁷ The question of its reach is taken up *infra* at Part C. See U.C.C. §§ 2-310(a); 2-511(1).

³⁸ 201 App. Div. 713, 194 N.Y.S. 638 (1922).

³⁹ *Id.* at 713, 194 N.Y.S. at 639.

pletes and tenders the goods. It may be taken as certain that any ambiguities in such a clause will be resolved against the seller, because such an option enables him to work a drastic change in the payment terms originally agreed upon.⁴⁰

The final alternative is a term authorizing the seller to demand only security for payment, perhaps a purchase money security interest in goods actually delivered. In some instances a buyer might be willing to agree to such a term where he would balk at one empowering the seller to eliminate credit and require cash. Otherwise, the option to eliminate credit entirely could always be used to obtain security, because if cash were demanded and the buyer was unable to comply with the demand, the seller could then offer to accept some type of security in lieu of cash.

C. *Conditions for Asserting Whatever Rights are Reserved*

The substantial drafting problem lies not in deciding what changes in payment terms the seller will be empowered to make, but rather in selecting the events which are to be conditions for asserting whatever rights are reserved to make those changes. A clause may be drafted to leave any withdrawal of credit to the seller's discretion, or, in the alternative, be keyed to some readily identifiable event beyond the seller's control.

In a contract requiring monthly deliveries with payment 30 days following each delivery, the buyer's right to credit could be conditioned upon his making payments strictly as due, so that any delay would authorize the seller to eliminate credit for subsequent deliveries. Such a term would work nicely, because the seller's right depends upon an easily identified occurrence, but it would not fully meet the seller's needs, because the buyer could make scheduled payments until the very eve of insolvency. Moreover, when the buyer is approaching insolvency, this term would not protect the seller during the interval between contracting and first delivery. The risk during this period could be reduced only by making the right to credit depend upon the buyer's remaining current on his debts to other parties.

A second type of term, apparently little or never used, would tie the buyer's right to credit to his maintenance of a specified ratio of current assets to current liabilities, or of a stated dollar amount of working capital. Under such a term the buyer would necessarily furnish audited financial statements to the seller. The term would give substantial protection to the seller, and the protection would be conditioned upon readily ascertainable facts. Although a term of this type seems reasonable, the seller would have a difficult time negotiating such a clause into a contract, be-

⁴⁰ In *Fulton Bag & Cotton Mills, Inc. v. Frankel*, 196 App. Div. 701, 188 N.Y.S. 709 (1921), *aff'd mem.*, 234 N.Y. 580, 138 N.E. 454 (1922), a clause specifying that "terms" were "subject to revision by the seller" was held not to authorize the seller to require payment before delivery.

cause a buyer who has an alternative source of supply or is otherwise in a strong bargaining position is quite likely to resist its inclusion.

An alternate way of saving at least a measure of control over the credit extended to the buyer is through a term which specifies that:

Seller shall have an unconditional right to require payment in cash for any goods to be delivered whenever in his sole discretion he deems himself insecure, and buyer must accept and so pay for goods tendered after any such demand is made.

What is unclear is exactly how much such a term would add to the rights which the seller already has by virtue of § 2-609. Section 1-203 declares that "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement,"⁴¹ and § 2-103(1)(b) provides that "'[g]ood faith' in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."⁴² As Comment 6 to § 2-609 indicates, the seller's dissatisfaction with his buyer's inability to pay could not be arbitrary, for ". . . any clause seeking to set up arbitrary standards for action is ineffective. . . ."⁴³ The seller's dissatisfaction must at least measure up to the "reasonable commercial standards of fair dealing in the trade."⁴⁴

One court has held⁴⁵ that a buyer must be given an opportunity to furnish assurances before the seller may rely on an insecurity clause to accelerate the time for payment of the price for goods already delivered. This means that the seller's statutory right to "adequate assurance of due performance" may not be enlarged by contract to a right eliminate the buyer's credit without first allowing the buyer to establish that he is in satisfactory financial condition. While the court was dealing with an acceleration of a past due balance, its reasoning could be applied to a term authorizing the seller to eliminate future credit if he "deemed himself insecure."

To eliminate any question about the seller's "good faith," the following is suggested:

Seller shall have an unconditional right to require payment for any goods to be delivered after 30 days have elapsed following notice given to the buyer that such payment shall be required, and buyer must accept and so pay for goods tendered after such period has elapsed.⁴⁶

⁴¹ U.C.C. § 1-203.

⁴² *Id.* § 2-103(1)(b).

⁴³ *Id.* § 2-609, Comment 6.

⁴⁴ *Id.* § 2-103(1)(b). *Accord*, James B. Berry's Sons Co. v. Monark Gasoline & Oil Co., 32 F.2d 74 (8th Cir. 1929). *Contra*, Corn Products Refining Co. v. Fasola, 94 N.J.L. 181, 109 A. 505 (1920).

⁴⁵ *Wrightstone, Inc. v. Motter*, 1 U.C.C. Rep. 170 (Pa. C.P. 1961).

⁴⁶ A combination type of term could be used; acceleration clauses for notes are often put in this form.

So stated, the term probably will not mislead the buyer to believe that credit will be continued if only he manages to keep in satisfactory financial condition. The buyer's financial condition is not, by the plain meaning of the term, a factor that conditions or limits the seller's right to insist on cash. Even so, it is debatable whether such a clause is enforceable, because § 1-208 provides that:

A term providing that one party . . . may accelerate payment or performance or require collateral "at will" or "when he deems himself insecure" or in words of similar import shall be construed to mean that he shall have power to do so only if he in good faith believes that the prospect of payment or performance is impaired⁴⁷

Whether this section applies to any term authorizing a seller to adjust or eliminate credit is questionable. On one hand, it is certainly possible to characterize a term by which the seller reserves an unconditional right to eliminate credit as one which allows him to "accelerate payment . . . at will."⁴⁸ On the other hand, it can be argued that the draftsman meant to reach only that term by which the seller may accelerate payment of a debt incurred for the price of goods⁴⁹ already delivered. But is the application of the section so limited? As noted above, the term usually referred to as an acceleration clause is used to reduce risks inherent in long term credit, while the clause at issue here would be drafted to meet the seller's risk of the buyer becoming insolvent in the relatively brief interval between contracting and delivery, or between deliveries. In considering the possible hardship to the buyer, there is an obviously great difference between eliminating a credit period of 36 months or more and withdrawing credit which would perhaps have run for only 30 days. Withdrawing credit and accelerating payment are simply not the same in common understanding and function.

The basic supposition is that the draftsmen of § 2-609, § 1-203, § 2-103, and § 1-208 were trying to protect buyers' and other debtors' reasonable expectations that an "insecurity" clause would not be invoked unless the debtor's financial condition began to worsen markedly. On the other hand, if the buyer is not misled about the character of the seller's right, a term authorizing the seller unconditionally to eliminate the right to credit should be enforced according to its plain meaning, unless such enforcement would otherwise be unconscionable.⁵⁰ And, because the buyer has a 30-day period in which to arrange for other credit, enforcement of the term suggested is probably not unconscionable.

⁴⁷ U.C.C. § 1-208.

⁴⁸ Would the seller have an option to accelerate "at will" if the term required that any elimination of credit had to be preceded by 30 days' notice?

⁴⁹ Liability for the price is not fixed until delivery. See U.C.C. § 2-507(1).

⁵⁰ See *id.* § 2-302.

